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COMMENTS

Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law

*John McDonald**

In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception — couched in abstract terms that offer no handle to seize hold of — leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

—Learned Hand[1]

* The author wishes to thank Thomas W. Bottomlee of Baker and McKenzie for his thoughtful comments.

1 This statement was made by Learned Hand. He was referring to the Internal Revenue Code of 1939, which could almost be described as simplistic compared to the provisions currently imposed by the Internal Revenue Code of 1986. James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7 (1989).

Nowhere is the complexity of the Code[2] more apparent than in the income tax provisions relating to U.S. ownership of foreign corporations.[3] In fact, the operation of the tax law in this area has become so incredibly complex that many calculations required by the Code can no longer be performed effectively without the use of sophisticated computer software.[4] The cost of complying with these Code provisions has started to affect the competitiveness of the corporations to which they apply.[5] In fact, there is a definite possibility that our tax laws in this area have become so complex that tax professionals may simply not be able to render accurate advice to their clients.[6] In order to determine why this area of the Code is so complex, the nature of the debate raging over the U.S. system of international taxation must first be understood.

There are four generally accepted bases of taxation:

- *Territorial Based Taxation* - all income derived from within the country's borders is subject to that country's tax.[7]
- *Source Based Taxation* - all income which can be sourced to that country will be taxed by that country.[8]

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2 Unless otherwise noted, all section references and code references shall be to the Internal Revenue Code of 1986 as amended.

3 "Like most parts of the Internal Revenue Code... the portion detailing the taxation of income from international transactions, has been the subject of almost constant congressional tinkering in recent years.... These rules were among the most arcane and complex in the Code at the inception of this process; they are now unparalleled in their intricacy." Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VA. L. REV. 919, 920 (1989).

4 Richard M. Hammer & Wesley N. Riemer, *Coping With Separate Foreign Tax Credit Limitations*, 1 J. INT'L TAX'N. 5 (1990).

5 "...I think we need to be very tough and hard in asking the question, is it worth the candle? Are we really achieving our policy objectives or are we simply raising the cost of doing business? Our data suggest that U.S.-based multinationals incur two to three times the cost of the foreign-based counterparts in simply complying with our tax laws and our securities laws. That is all bottom- line money. I believe it undermines their competitive position. It is not trivial in amount, and I think that we just need to be as aggressive as we can in saying, are all these provisions, all these rules, really necessary in light of what we are trying to accomplish?" *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings on H.R. 5270*, 102d Cong., 2d Sess. 256-257 (1992) [hereinafter *Hearings*] (statement of Hon. Fred T. Goldberg, Assistant Secretary for Tax Policy).

6 In response to the question whether people both in the IRS and in the private sector can even administrate certain areas of international tax law, Mr. Goldberg stated that in fact it was true that certain areas of international tax law have ceased to be administrable. *Id.* (statement of Hon. Fred T. Goldberg, Assistant Secretary for Tax Policy).

7 Ronald M. Warren, *Investment in United States Property by Controlled Foreign Corporations: A Proposal for Reform*, 19 RUTGERS L.J. 367, 369 (1988).

8 *Id.* For an insightful discussion of how foreign individuals and corporations may be subject to U.S. income tax on income sourced to the United States, *see* PHILIP F. POSTLEWAITE & TAMARA L. FRANTZEN, INTERNATIONAL TAXATION §§ 4.01, 5.01 (1995).

- *Residence Based Taxation* - all the income of a nation's residents is taxed regardless of where it was earned.[9]
- *Citizenship Based Taxation* - all the income of a citizen of a particular nation is taxed by that nation regardless of where the income is earned.[10]

The United States utilizes all four bases of taxation.[11] By employing such a broad taxing jurisdiction the Code reaches more taxpayers and conduct than most other nations,[12] and necessarily includes the income earned by U.S. owned foreign corporations.

The United States also adheres to a "classical double tax system" which means that corporate income is taxed at two levels, once when a corporation earns income and a second time when that corporation makes a dividend to its shareholders.[13] This two level tax also applies if a U.S. shareholder invests in a foreign corporation.[14] There are two forms that this investment can take. First, a U.S. shareholder can invest in a domestic corporation, known as a U.S. multinational corporation (MNC), which invests in foreign corporations. Second, a U.S. shareholder could purchase shares directly in a foreign corporation. Either way, one tax will be assessed at the foreign corporation's level, and a second shareholder level tax will be imposed when a dividend distribution is paid.

A foreign corporation can delay the U.S. shareholder level tax indefinitely, however, by simply refusing to make dividends to its U.S. shareholders. This concept, known as "deferral," does not decrease the amount of dollars the U.S. shareholder will eventually have to pay, but it does decrease the *present value* of her tax liability. This is because a dollar paid to the U.S. Government three years from now is less valuable than a dollar paid to the U.S. Government today.

Simply phrased then, the international tax debate revolves not so much around "how much" tax is paid on income earned abroad. Rather, the debate has traditionally focused on "when" U.S. taxes on income earned by foreign corporations are paid. U.S. shareholders generally argue that they should be allowed to push income recogni-

9 Ronald M. Warren, Note, *Investment in United States Property by Controlled Foreign Corporations: A Proposal for Reform*, 19 RUTGERS L.J. 367, 369 (1988).

10 *Id.* at 369.

11 *Id.* at 369.

12 Christopher J. Lord, Note, *Stapled Stock and I.R.C. Section 269B: Ill-Conceived Change in the Rules of International Tax Jurisdiction*, 71 CORNELL L. REV. 1066, 1068 (1986).

13 Richard Doernberg, *International Aspects of Individual and Corporate Tax Integration*, 92 TAX NOTES INT'L 12-22 (1992).

14 *Id.*

tion into the future and Congress and the Treasury generally attempt to require current income recognition.

In order to prevent deferral from substantially decreasing tax revenue, Congress has developed numerous devices which limit deferral possibilities. These devices, known as "anti-deferral regimes," operate by imposing the U.S. shareholder level tax on a U.S. shareholder's proportionate share of a foreign corporation's income BEFORE an actual dividend is made.

The trend has been for Congress to make each successive anti-deferral regime more aggressive in limiting deferral opportunities. These regimes are arguably the most complex provisions of the rules governing international taxation. Unfortunately, however, these regimes were each developed to prevent a particular type of deferral which Congress thought was abusive. They were not developed to promote one overarching tax goal. As a result, they overlap and cause considerable confusion.

The purpose of this comment will be to demonstrate that the international tax provisions of the Code will never be simplified until policy makers first answer the question, "What goal is the United States trying to advance through its system of international taxation?" Many analysts, and even the Treasury Department itself, have addressed this question. In an attempt to resolve this dilemma, this paper will: 1) outline the goals currently being pursued in international taxation; 2) describe each anti-deferral regime, and how each manages to both foster and hinder different international tax goals; 3) analyze one example of reform legislation and assess its impact on international tax goals; 4) develop an analytical framework in order to determine what the United States' primary international tax goal should be; and 5) outline the basic principles of an anti-deferral regime to further that goal.

I. U.S. Goals in International Taxation

The United States' pursuit of a myriad of unprioritized objectives is *the* driving force behind the complexity in the U.S. system of international taxation. Hence, no reform can really be labeled "successful" because a change that may improve the Code with respect to one goal may actually make the Code worse with respect to another goal.

Five major goals being pursued by the U.S. currently[15] are:

[15] *Hearings, supra* note 5, at *id.* (statement of Hon. Fred T. Goldberg, Assistant Secretary for Tax Policy).

- Simplification - making the administration of the tax laws easier.[16]
- Efficiency - the idea that the tax law should not distort the efficient allocation of resources.[17]
- Competitiveness - the idea that U.S. corporations should not be placed at a tax disadvantage in either the international or domestic market.[18]
- Compatibility With International Tax Norms (Compatibility) - which seeks elimination of double taxation, and nondiscrimination between foreign and domestic investment.[19]
- Preservation of the U.S. Tax Base (Preservation) - the idea that the U.S. should seek to prevent people and taxable economic activities from leaving the country.[20]

Since no single tax system can simultaneously advance all five goals, they compete against each other for influence. This competition has resulted in a compromise "two-pronged" approach which allows foreign corporations owned by U.S. shareholders to defer income as a general rule,[21] but subjects passive income to current taxation.[22]

In other words, usually a U.S. shareholder of a foreign corporation will not add the profits of her foreign corporation's active manufacturing operations to her gross income when that income is earned by the foreign corporation. Rather, the corporation's income from active manufacturing operations is deferred until the foreign corporation pays a dividend to the shareholder, at which time that dividend is included in the U.S. shareholder's income.[23] However, when the foreign corporation earns income which is particularly mobile[24] and pas-

16 Simple rules are essential for four basic reasons: 1) they are less expensive to apply; 2) simple rules minimize friction and transition costs; 3) they facilitate compliance and foster respect for the tax system; and 4) they increase voluntary compliance. *Hearings, supra* note 5, at *id.*

17 *Hearings, supra* note 5, at *id.*

18 *Hearings, supra* note 5, at *id.*

19 *Hearings, supra* note 5, at *id.*

20 *Hearing, supra* note 5, at *id.*

21 "United States tax law has included tax deferral of the income from foreign subsidiaries since the inception of the corporate income tax in 1913." Glen M. Secor, Note, *Runaway Plants, Runaway Tax Policy: The Continuing Debate Over the Taxation of Controlled Foreign Corporations*, 16 SUFFOLK TRANSNAT'L L. REV. 200, 203 (1992).

22 *Hearings, supra* note 5, at *id.*

23 I.R.C. § 301(c).

24 Throughout this comment "mobile" refers to income which can be earned anywhere on the globe with minimal or no effort. For example, dividends on General Motors stock can be earned in the United States or Mexico, depending solely on where the recipient resides. However, income from the sale of cars can only be earned where the cars are in fact sold. Therefore, dividends are referred to as mobile, whereas income from active operations is not mobile.

sive,[25] the shareholder is taxed currently through a series of "anti-deferral regimes."

Each anti-deferral regime was developed to further one or more international tax goals. However, as this comment will demonstrate, the interaction between these regimes fosters competition between international tax goals without significantly advancing any single goal. These regimes are explained in detail below.

II. The Anti-Deferral Regimes Examined

There are five anti-deferral regimes which subject U.S. shareholders of foreign corporations to current income taxation prior to the corporation's payment of a dividend. Each regime advances and hinders different international tax goals. Section A of this part will describe each of these regimes. Section B will address the problems which can arise when more than one of these regimes apply to the same corporation. Lastly, section C will address the complications created by the operation of the foreign tax credit in conjunction with each regime. Interspersed throughout the sections will be an analysis of how each regime interacts with the goals of international taxation.

A. The Regimes Described

1. Accumulated Earnings Tax

The first anti-deferral regime Congress developed was the Accumulated Earnings Tax.[26] This regime applies to both domestic and foreign corporations.[27] Its purpose is to prevent U.S. citizens or residents from throwing their money into corporations formed solely for the purpose of holding its shareholders' investments. Such an arrangement has the advantage of deferring the tax associated with the income earned on such investments to future years. The regime operates by imposing a 39.6% tax on any earnings and profits of a corporation which are allowed to accumulate beyond the "reasonable needs of the business."[28] However, this regime is easily sidestepped

25 Passive income simply refers to income earned by a recipient who is not actively engaged in the business which produced the income (i.e. - dividends, rents, royalties etc.).

26 William H. Hoffman, Jr. & Mary Sue Gately, *Post-1984 Act Planning to Avoid Taxation of Foreign Personal Holding Company Income*, 64 J. TAX'N. 92 (1986).

27 Domestic and foreign corporations are subject to the Accumulated Earnings Tax unless they are determined to be either a: 1) Personal Holding Company; 2) Foreign Personal Holding Company; or 3) a Passive Foreign Investment Company. In that case the corporation will be exempt from the Accumulated Earnings Tax by § 532(b). Treas. Reg. § 1.532-1.

28 I.R.C. § 531 imposes a tax on the Accumulated Taxable Income(defined in § 535). Accumulated Taxable Income is an amount which exceeds the amount of earnings and profits that a

because a reasonable business need can be manufactured without substantial difficulty.[29]

The very existence of this regime as a trap for unwary tax planners hinders the goal of Simplicity. However, it does attempt, unsuccessfully, to preserve the tax base by preventing unlimited deferral abroad.

2. *Foreign Personal Holding Company Regime*

In 1937, Congress developed something called the Foreign Personal Holding Company (FPHC) regime,[30] which operates by including the undistributed FPHC income of a FPHC in the gross incomes of its U.S. shareholders.[31] A FPHC is defined as any foreign corporation which: 1) has at least sixty percent of its gross income as FPHC income; and 2) at any time during the taxable year more than fifty percent of the company (measured by vote or value) is owned by five or fewer U.S. citizens or residents (the U.S. group).[32] FPHC income is defined as dividends, interest, rents, royalties, and gains from the sale of stocks or commodities.[33] Therefore, the FPHC regime targets corporations earning large amounts of passive income.

The FPHC regime attempts to preserve the tax base by eliminating certain deferral opportunities. However, it definitely hinders the goal of Competitiveness by subjecting U.S. shareholders to current taxation on their foreign operations.

3. *Subpart F Regime*

Prior to 1962, U.S. shareholders could still create corporations in low tax jurisdictions and "owe no U.S. tax until funds were distributed from the foreign corporation."[34] However, President Kennedy be-

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business would reasonably need. How much income a business would reasonably need is defined in § 537.

29 Hoffman, *supra* note 26. After all, Treas. Reg. § 1.537-1(b) states that reasonably anticipated needs include any plan which is specific, definite and feasible. Therefore, to avoid the regime, all one needs to do is to develop a specific plan to invest the company's earnings and profits in order to escape the regime. The money does not, in fact, have to be spent on anything.

30 Due to the problems inherent in asserting taxing jurisdiction over foreign entities, Congress for the first time made the U.S. shareholder the target of the regime. The AET adds an additional tax to the corporation itself. The FPHC regime works differently. The FPHC regime "imputes" the income from the company to the shareholder and then taxes the U.S. shareholder on that income, whether or not the shareholder has received a distribution from the corporation. Hoffman, *supra* note 26.

31 I.R.C. § 551(a).

32 I.R.C. § 552(a)(1) & (2).

33 I.R.C. § 553(a).

34 Walter D. Schwidetzky, *Subpart F, 1986 and Beyond*, 17 U. BALT. L. REV. 213, 215 (1988).

lieved that the existence of tax haven countries,[35] and the opportunities for deferral which they created, caused U.S. shareholders to invest heavily abroad, thereby upsetting the efficient allocation of resources.[36] In 1962, Kennedy sought a complete end to deferral, whereby U.S. shareholders would pay U.S. tax currently on any income they earned from foreign corporations.[37] However, large U.S. corporations were opposed to this solution and a compromise was reached whereby deferral would be ended only for those types of income which were deemed abusive.[38] This compromise is known as the Subpart F regime.

The Subpart F regime only applies to controlled foreign corporations (CFCs). A foreign corporation becomes a CFC if more than fifty percent of the corporation (measured by vote or value) is owned by U.S. persons.[39] Unlike the AET, PHC and FPHC regimes, which only target corporations earning large amounts of passive income, the Subpart F regime applies to any CFC, regardless of what type of income it generates.

Subpart F's minimum ownership requirement creates a potential loophole whereby an investor can avoid the perils of current taxation by simply reducing his or her ownership levels below that required under the regime. The obvious problem with this strategy, however, is that the investor loses control over its foreign subsidiary.

Before 1984, however, domestic corporations with overseas subsidiaries could utilize something called "stapled stock arrangements."[40] If the domestic corporation was widely held, this maneuver dispersed ownership, prevented the foreign corporation from meeting the control requirements of Subpart F, or the FPHC regime for that matter, and at the same time allowed a parent corporation to retain control of its subsidiary, because the same group of shareholders owned both the parent and the subsidiary.[41]

Congress passed I.R.C. § 269B in response to this opportunity. Section 269B provides that if a domestic and foreign corporation are

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35 Countries which impose very low or zero rates of tax on investment in their countries.

36 Warren, *supra* note 7, at 375.

37 Warren, *supra* note 7, at 375.

38 Warren, *supra* note 7, at 376.

39 I.R.C. § 957(a).

40 A stapled stock arrangement occurs when one corporation links its stock to that of another independent corporation such that any disposition of an interest in one of the corporations causes a simultaneous disposition of an interest in the other stapled corporation. *See* Lord, *supra* note 12, at 1073.

41 *See* Lord, *supra* note 12, at 1066.

considered to be "stapled," the foreign corporation will be considered a domestic corporation, subject to current U.S. taxation.[42]

Section 269B has been criticized as a radical departure from accepted rules of international tax jurisdiction.[43] Whereas Subpart F imposes a tax on the U.S. shareholder, § 269B actually asserts taxing jurisdiction over a foreign corporation, as if it were a domestic corporation.[44] In order to accomplish this, § 269B unilaterally overrides any treaty obligation that the U.S. may have had that would protect that foreign corporation from current taxation.[45] Although Congress was within its power to do so, "this unilateral modification of bilaterally negotiated treaties seriously jeopardizes [the treaties'] viability and the continued cooperation of treaty partners."[46] As a result, § 269B constitutes a serious violation of international tax norms and a sacrifice of the international tax goal of Simplification.

Subpart F operates by requiring each U.S. shareholder[47] of a controlled foreign corporation to include in income: 1) his or her pro rata share of the corporation's Subpart F income for such year, and 2) his or her pro rata share of the corporation's increase in earnings invested in United States property for such year.[48] Subpart F income, the type of income which the Subpart F regime targets, has been referred to as "tax haven" type income.[49] This income tends to be of a type which is easily moved from one taxing jurisdiction to another and is typically subject to low rates of tax in many foreign jurisdictions.[50]

As originally conceived, the Subpart F regime could be avoided by having the CFC repatriate its earnings in the form of U.S. investments which were beneficial to the CFC's shareholders.[51] Subpart F

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42 I.R.C. § 269B(a)(1).

43 Lord, *supra* note 12, at 1087.

44 Lord, *supra* note 12, at 1087-88

45 I.R.C. § 269B(d).

46 "The important role played by tax treaties in United States tax policy greatly outweighs the anticipated increase in tax revenues generated by § 269B." Lord, *supra* note 12, at 1090.

47 U.S. shareholder is defined as any U.S. person who owns or is considered to own ten percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. I.R.C. § 951(b).

48 I.R.C. § 951(a)(1)(A) & (B).

49 William J. Bricker, Jr., *Subpart F*, at 2 (PLI TAX L. & EST. PLAN. COURSE HANDBOOK SERIES TAX L. & PRAC., 1989).

50 H.R. Rep. No. 353, 103d Cong., 1st Sess., at 79 (1993).

51 For example, assume a U.S. MNC wishes to build a plant in America. Instead of having a foreign subsidiary declare a dividend to the U.S. MNC, which would then purchase the plant, the U.S. MNC could simply force the foreign subsidiary to buy the plant directly. If the U.S. MNC controls 100% of the stock of the foreign subsidiary, it would still indirectly control the plant and it would escape the U.S. taxation that would result from a dividend.

was amended, however, and now subjects the earnings of a CFC which are reinvested in U.S. property to current taxation.[52]

Treas. Reg. § 1.956-2T(d)(2) closes a loophole in the application of the aforementioned amendment to Subpart F. Before this regulation was released in 1988, a loan from a CFC to a domestic corporation was NOT considered to be an investment in U.S. property if it was collected within a year from the time it was made.[53] Therefore, CFCs could avoid having a Subpart F inclusion, and subjecting their shareholders to current taxation, by making a loan to its U.S. parent, having the loan repaid before the end of the year, and making a new loan on the first day of the next year.[54] In response, the Treasury Department created § 1.956-2T(d)(2), which mandated that any such loans between related parties would have to be "ordinary and necessary" to carry on the business of the two corporations, determined as if they had been unrelated.[55] Congress went even further, however, in 1993 and revised Subpart F so that the amount of a foreign subsidi-

52 The scenario referred to in the previous footnote is prevented by § 956(c)(1) which states that tangible property located in the U.S. is considered U.S. property. Section 956(a)(2) then imputes to the U.S. shareholder his or her pro rata share of that investment, to the extent that it would have constituted a dividend had it been distributed. Treas. Reg. § 1.956-1(b)(1).

For example, assume that A is a U.S. Corporation directly owning 60% of a foreign corporation R, which is a controlled foreign corporation. On 12/31/95, Corporation R owned $150,000 of U.S. property, which would constitute a dividend if distributed on such date. Also assume that R made $50,000 of actual distributions during 1964, which were previously included in the income of its U.S. shareholders. Further assume that R has $250,000 of U.S. property investments, $225,000 of which would otherwise constitute a dividend if distributed on 12/31/96. A's pro rata share of R's investment in U.S. property would be equal to:

U.S. Investments on 12/31/96		$250,000
Earnings and Profits 12/31/96		$225,000
U.S. Investment 12/31/95	(150,000)	
Previously taxed 1995 distributions	50,000	$100,000
Increase in U.S. investment for the year:		$125,000

A's share of R's $100,000 increase in U.S. investment for the year would be 60% of $125,000 or $75,000. This $75,000 would then be subject to current income taxation under § 951(a)(1)(B). *See* Treas. Reg. § 1.956-1(d) *Example 1.*

It should be noted that Congress took an even bolder step towards the elimination of deferral under the Subpart F regime with the enactment in 1993 of 956A, which imposes current taxation on a CFC if it simply accumulates excess amounts of passive income. For an extremely thorough and insightful discussion of this new wrinkle on Subpart F and its implications for tax planning see John M. Peterson, Jr., et. al., *A Passive-Aggressive Approach to Anti-Deferral in the 1990s: Critical Analysis and Planning Techniques Under Section 956A*, 72 TAXES 1084 (1994).

53 *Hearings, supra* note 5, at *id.* Recall that if a foreign subsidiary holds an obligation of a U.S. person they are deemed to have an investment in U.S. property under § 956 which is then imputed to the U.S. shareholder through § 951 and subjected to current taxation.

54 *Hearings, supra* note 5, at *id.*

55 Treas. Reg. § 1.956-2T(d)(2)(B).

ary's assets invested in United States property would be measured every quarter instead of every year.[56]

By closing this loophole, Treasury and Congress furthered Efficiency by removing tax considerations as a motivation for CFCs to invest in the United States. However, at the same time they sacrificed Simplicity, because CFCs are now forced to account for their assets four times as often as they used to, and Preservation, because CFCs will be encouraged to reinvest abroad instead of reinvesting their accumulated profits in the United States!

4. *Foreign Investment Company Regime*

If a shareholder is willing to forego the advantages of deferral, he or she can eliminate the double taxation inherent in corporate investments by investing in a Regulated Investment Company (RIC).[57] RICs are treated as pass-through entities for tax purposes and so do not pay a corporate level tax.[58] However, taxpayers soon learned that they could get the advantage of deferral as well as one level of taxation if they invested in offshore investment funds.[59] A foreign investment fund will only be taxed by the U.S. at the corporate level if it has income from sources within the United States,[60] and the U.S. investor will pay no tax on the income until she receives a dividend.[61] Congress therefore became concerned that these foreign funds were not paying any U.S. taxes.[62]

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56 The Senate report accompanying the bill suggests that this provision is intended to be applied so as to disregard any short term loans where one of the principal purposes is the avoidance of taking assets into account for purposes of § 956. S. Rep. No. 103-66, 103d Cong., 1st Sess., at 12 (1993).

57 Section 851(a)(1) defines a Regulated Investment Company as any domestic corporation registered as either a management company or a unit investment trust under the Investment Company Act of 1940.

58 More specifically, assuming that an RIC distributes 90% or more of its income every year, § 852(b)(2)(D) allows the RIC a dividends paid deduction. Therefore, it is more exact to say that any income distributed by the RIC will only be taxed once at the shareholder level.

59 *See* Jacob Mertens, Jr., Law of Federal Taxation § 45H.01 (David B. Newman ed., 1994).

60 I.R.C. § 871. However, even if the foreign fund has investments in the United States it will be subject to a flat 30% tax. Generally, a foreign corporation will pay regular corporate rates of tax on any income effectively connected with a trade or business in the United States. I.R.C. § 871(b)(1). However, I.R.C. § 864(b)(2) states that trading in securities will NOT be considered a trade or business in the United States. Therefore, the income from such investments will probably be considered FDAP or fixed determinable annual or periodic income which is subject to a flat 30% tax imposed on a gross basis.

61 I.R.C. § 301.

62 "Under present law a foreign investment company usually pays no U.S. income tax, since U.S. tax is imposed only on income derived from sources within the United States and such

Congress developed the Foreign Investment Company (FIC) regime in response to this abuse.[63] A FIC is any foreign company which, at a time when fifty percent or more of the vote or value of the company is held directly by U.S. persons, either: 1) is registered under the Investment Company Act of 1940 as a management company or a unit investment trust; or 2) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest in commodities or securities.[64] The regime provides that the gain from any sale of FIC stock would be ordinary income, rather than capital gain income unless the FIC distributes ninety percent of its income to its shareholders.[65]

This regime became irrelevant for a number of reasons. First, it required U.S. control, so U.S. investors in foreign controlled funds were completely exempt from the regime.[66] Second, the penalty for being an FIC (ordinary income treatment of gain on sale of FIC stock) lost its punitive edge when the marginal tax rates on capital gain and ordinary income were integrated.[67] Finally, it is very difficult for a company to be an FIC and not be a Passive Foreign Investment Company, a characterization which subjects the corporation to a much more stringent regime.[68] Nevertheless, it remains as a trap for the unwary and thereby only serves to hinder the goal of Simplicity without any corresponding advancement of other international tax goals.

5. *Passive Foreign Investment Company Regime*

The Passive Foreign Investment Company (PFIC) regime accomplished what the FIC regime set out to do, which was to eliminate any incentive U.S. investors would have to invest in offshore investment funds.[69] A foreign corporation is a PFIC if: 1) seventy-five percent or

companies generally have no U.S. securities and, therefore, have no income from U.S. sources." S. Rep. No. 1881, 87th Cong., 2d Sess., 101 (1962).

63 *See* Mertens, *supra* note 59.

64 I.R.C. § 1246(b).

65 I.R.C. § 1246(a)(1); I.R.C. § 1247(a).

66 David A. Tillinghast, *International Tax Simplification*, 8 Am. J. Tax Pol'y 187, 202-03 (1990).

67 *Id.* It should be noted, however, that the motivation for avoiding the FIC regime may be stronger now that the highest marginal rate is 39.6%, whereas the capital gains tax rate is capped at 28%. I.R.C. § 11. As the disparity between these two numbers grows, the FIC regime will become more important again.

68 *See* Tillinghast, *supra* note 66, at *id.* This is because the purpose of a foreign investment company is to hold passive investments, and substantial amounts of passive investments will subject a corporation to the Passive Foreign Investment Company Regime.

69 *See* Richard J. Shapiro & Roger D. Lorence, *PFICs Pose Significant Hazards for U.S. Investment Companies*, 2 J. Int'l Tax'n. 185 (1991).

more of its gross income is passive income;[70] or 2) fifty percent or more of the average value of the assets held by such corporation during the taxable year produce passive income or are held for the production of passive income.[71]

The PFIC regime ends deferral in either of two ways. First, a taxpayer may, pursuant to I.R.C. § 1295, make an election to have his investment treated as a qualified electing fund (QEF). A taxpayer making such an election includes his pro rata share of the foreign corporation's earnings in gross income every year.[72] These income inclusions increase the shareholder's basis in his or her PFIC stock.[73] Second, the shareholder may, alternatively, fail to elect QEF status and therefore be subject to the "interest charge method."[74] Under this mechanism, if a PFIC makes a distribution which is considered excessive,[75] the excessive portion of that distribution will be allocated ratably over the shareholder's holding period for that stock.[76] Then, an interest charge will be assessed on those amounts allocated to prior years.[77] By charging interest on the income the PFIC has deferred, this method eliminates any benefit the shareholder would ordinarily derive from postponing dividends and pushing the corresponding income inclusion into the future.[78]

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70 Passive income for purposes of the PFIC regime is defined in I.R.C. § 954(c) as interest, rents, royalties and annuities or any property transactions which give rise to the foregoing types of income.

71 I.R.C. § 1296(a).

72 I.R.C. § 1293(1); Any amount thus included retains its character as either ordinary income or capital gain as per § 1293(a)(1)(A) & (B).

73 I.R.C. § 1293(d).

74 I.R.C. § 1291(a).

75 An excessive distribution is defined as any distribution which exceeds 125% of the average of the three previous year's distributions. I.R.C. § 1291(b).

76 I.R.C. § 1291(a).

77 I.R.C. § 1291(c)(3).

78 For example, assume that P, a U.S. shareholder owns 100% of S, a PFIC. S earns:

1988	1989	1990	1991
225	225	225	275

However, assume that S only chooses to distribute:

1988	1989	1990	1991
200	200	200	350

If P has made a QEF election, then P will include 100% of S's income in its gross income for each of the years 1988-1991. If P has not made this election, P will have deferred recognition of $75 of S's income to 1991. This is because S earned $25 more than it distributed in each of the previous three years. If no QEF election is in effect, P does not have to include all of S's income in his income. However, P must still recognize income equal to the amount of distributions received.

The PFIC regime is very draconian because it eliminates the incentives for deferral, and unlike the FIC, FPHC, and Subpart F regimes, it has no control requirement. Therefore, anyone caught deferring income will be penalized, not just large shareholders. It may be that the PFIC regime goes a little too far. In fact, one commentator has dubbed it, "a prime example of legislative overkill."[79]

The PFIC regime has problems in: 1) its basic operation; and 2) the companies that it targets. Each problem illustrates how international tax goals are forced to compete with each other for dominance.

a) Basic Operation

1. *Income Allocation*

A major problem for the PFIC regime is that it may penalize a corporation that has not deferred any income![80] Although the inter-

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Without the interest charge regime, the $75 would be taxed in 1991. This deferral would have two advantages. First, if tax rates went down between 1988 and 1991, the after tax return on the income would obviously be higher. Second, even if tax rates remain the same, P has decreased the present value of his tax liability.

However, this advantage will not be realized because of the interest charge method. Since the 1991 distribution exceeds 125% of the average of the three preceding years' distributions, $100 of the 1991 distribution will be considered an "excess distribution" as per § 1291(b). Assuming that P has held this stock since the beginning of 1988, $25 will be allocated to each year from 1988 to 1991 as per § 1291(a)(1)(A), and that $25 will be subject to the highest marginal rates existing in that year. § 1291(c)(2). Moreover, since P did not pay tax on these amounts in the years to which they relate, he will have to pay interest assessed under § 6621 on each allocation. § 1291(c)(3). For example, if we assume the highest marginal tax rate in existence in 1988 was 34%, the tax owed on only the $25 allocated to 1988 will be = $25 X 34% = $8.50 of tax due on March 15, 1989. The tax liability then incurs interest, computed under § 6621, from March 15th of 1989 until it is paid in March of 1992!

79 Tax Executives Institute, *Comments on Proposed Tax Simplification Legislation*, 43 TAX EXECUTIVE 339, 342 (1991)

80 Assume that S is a PFIC which earns:

1988	1989	1990	1991
0	0	0	325

Also assume that S does not qualify for the start up company exemption of § 1297(b)(2).
S distributes:

1988	1989	1990	1991
0	0	0	325

In this example there has been NO DEFERRAL! S has distributed all of its income in the years in which it was earned. Nevertheless, since the 1991 distribution exceeds 125% of the average of the three preceding years' distributions, (because $325 > 125% X (0+0+0)/3) it will be deemed an excess distribution and will be allocated pro rata over the shareholder's holding period. Therefore, in this situation, S and P would be better of if S slowly ratchets up the distributions in order to increase the three year average. But this is clearly not the result desired because that would increase deferral!

est charge method preserves the tax base by discouraging an outflow of capital, it may thwart the goal of Efficiency by providing an incentive to invest in the U.S..

For example, a U.S. taxpayer who invests in an RIC will generally not get the benefits of deferral, because the RIC will distribute its income currently to avoid paying the corporate level tax.[81] Similarly, a U.S. shareholder in a PFIC will ordinarily not get the benefits of deferral because she will be taxed currently on the PFIC's income under either the QEF election or the interest charge regime. Yet, the shareholder of an RIC will never be taxed for years when no income is earned. However, a U.S. shareholder of a PFIC may in fact be subject to an interest penalty on income allocated to years when no income was earned. As a result, a U.S. investor is better off investing in a domestic corporation that is considered an RIC than a foreign corporation considered a PFIC.

2. *Double Taxation*

Since the interest charge method is not linked to the income of the foreign subsidiary,[82] its application may result in a taxation of basis! For example, assume domestic corporation P buys all of the stock of foreign corporation S for $1,000. S earns:

1988	1989	1990	1991
100	100	100	100

S distributes:

1988	1989	1990	1991
100	100	100	500

This same problem manifests itself in a sale of PFIC stock. *See* Ernest R. Larkins, *International Commerce Through a Foreign Subsidiary: Navigating the Anti-Haven Tax Shoals of the Internal Revenue Code*, 9 INT'L TAX & BUS. LAW. 64, 75 (1991). Specifically, if a shareholder sells PFIC tainted stock, the gain is considered a distribution under § 1291 and therefore may be considered an "excess distribution" subject to the interest charge method. Treas. Reg. § 1.1291-3(a). Moreover, § 1291(d) states that even a pledge of PFIC stock as security for a loan will be considered a distribution which may be subject to the interest charge regime. The amount of the pledge considered to be a distribution is the lower of the fair market value of the stock pledged or the unpaid principle of the loan secured - the basis in the PFIC stock. Treas. Reg. § 1.1291-3(d)(1).

81 RICs get a dividends paid deduction if 90% of its income is distributed. I.R.C. § 852(b)(2)(D).

82 Stephen E. Shay, *The Taxation of Passive Foreign Investment Companies*, 270 PUB. L. INST. TAX 37 (1988).

$375 of the 1991 distribution will be treated as an excess distribution[83] and will be allocated ratably over P's holding period. But $100 of that $375 is a return of the initial investment! This situation is just as if someone gave $100 to a foreign corporation which returned it two years later. No income has been deferred, and no U.S. taxes have been avoided. Nevertheless, P will be assessed an interest charge when the PFIC simply returns his basis in the stock.

Although this anomaly may help preserve the tax base (by penalizing foreign investment), it sacrifices the goal of Efficiency, because shareholders in a domestic corporation are not taxed on returns of their initial capital contribution. This anomaly also violates the goal of Compatibility. After all, taxing basis, which was purchased with after-tax dollars, is similar to double taxation, which is contrary to international tax norms.[84]

b) The Companies that PFIC targets

It has already been noted that a company can be a PFIC if it meets either the seventy-five percent gross income requirement or the fifty percent asset requirement.[85] Both tests have been criticized as being overly draconian by sweeping too many active manufacturing companies into the PFIC net.[86]

1. The Income Test

It is very easy for an active manufacturing enterprise to fail the income test and wind up being classified as a PFIC.[87] This provides a

[83] (100 +100+100)/3 * 125% = $125. 500-125 = $375 excess distribution.

[84] This income allocation anomaly can actually be manipulated to the shareholder's advantage. For example, if you know that your business will have substantial increases in earnings in future years, when you expect marginal rates to be higher, it would make sense to fail to make the QEF election and be subject to the interest charge method. When the PFIC actually does make a distribution, much of it will be allocated back to those years in which the highest marginal rates were lower. (It is important to note however, that the shareholder would have to be able to invest money at a rate at least equal to or exceeding the rate imposed by the interest charge method or else this scheme would not make sense.) *See* Larkins, *supra* note 80, at 76 for a demonstration of how the income allocation method operates.

[85] I.R.C. § 1296(a)(1).

[86] "Many, if not most, active foreign subsidiaries of U.S. parents are PFICs though the U.S. parents may not be aware of this." John S. Karls, *New PFIC Regs. Have Strong Impact on Active Foreign Subsidiaries*, 3 J. INT'L TAX'N. 133 (1992).

[87] For example, assume that an active wholly-owned foreign subsidiary of a U.S. MNC incurs $10,000,000 in cost of goods sold. Further assume that the subsidiary, in response to competitive pressures, decided that it could not raise its prices above the break even point and so had $10,000,000 in revenue. Although the subsidiary has no active income, it does have a bank account from which it derives $100 of interest during the year. This active manufacturing subsidiary is a PFIC and will remain a PFIC in every subsequent year. In order to avoid the PFIC

disincentive for U.S. shareholders to create manufacturing companies abroad, which helps to preserve the U.S. tax base. However, it does so at the expense of Competitiveness, because foreign owned competitors are not subject to the PFIC regime.

2. *The Asset Test*

It is also very easy to fail the asset test and thereby trigger the application of the PFIC regime.[88] For example, many U.S. shareholders develop foreign marketing subsidiaries, which act as sales agents in order to sell their goods overseas.[89] These marketing subsidiaries rarely take title to the goods and so have no inventory or trade receivables.[90] It is likely, then, that the marketing subsidiary's only asset will be a bank account from which expenses are paid.[91] If this is the case, the marketing subsidiary, although an integral part of an *active* manufacturing venture, will be considered a PFIC.[92]

It becomes particularly easy to fail the asset test when the look through rules apply.[93] As a result, U.S. shareholders usually try to

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regime, the active manufacturing subsidiary would have to refrain from the competitive price cut. John S. Karls, *PFIC/PFC Planning for Active Foreign Subsidiaries*, 2 J. INT'L TAX'N. 205 (1991).

88 It is so easy to fail that the Senate actually introduced legislation in 1991 in order to repeal the asset test. Senator Moynihan stated in support of the bill: "It is that asset test that has been the most difficulty, because a company can flunk and be considered a PFIC for any number of innocent reasons, even though it is genuinely and predominantly engaged in the conduct of active business operations. . . . [T]he rules have come to encourage practices motivated by tax planning that distort sound business decisions — such as delaying the collection of accounts receivable to avoid failing the asset test. But most importantly, experience with the asset has shown that it imposes the PFIC loss-of-deferral penalty in an arbitrary and overly broad way on companies that were not intended to be penalized."137 CONG. REC. S12219 (statement of Senator Moynihan). The bill, however, was not enacted.

89 John S. Karls, *PFIC/PFC Planning for Active Foreign Subsidiaries*, 2 J. INT'L TAX'N. 205 (1991).

90 *Id.*

91 *Id.*

92 I.R.C. § 1296(a)(2) states that a corporation will be a PFIC if 50% or more of its assets produce passive income. According to the Treasury Department, "Cash and other current assets readily convertible into cash, including assets which may be characterized as the working capital of an active business, produce passive income. . . ". I.R.S. Notice 88-22, 1988-1 CB 489.

93 I.R.C. § 1296(c). Under the look through rules, if a U.S. MNC owns a foreign corporation (1st tier subsidiary), which in turn owns more than 25% of another foreign corporation (second tier subsidiary), that second tier subsidiary's assets will be imputed to the first tier subsidiary for the purposes of the asset test. § 1296(c). However, these assets are imputed on a gross basis! I.R.S. Notice 88-22, 1988-1 CB 489. This means that if the second tier subsidiary has only one passive asset worth $1,000,000 purchased with $10,000 of equity financing and a $990,000 loan, $1,000,000 of the asset is imputed to the first tier subsidiary, not the $10,000. Richard J. Shapiro and Roger D. Lorence, *PFICs Pose Signifcant Hazards for U.S. Investment Companies*, 2 J. INT'L TAX'N. 185 (1991).

structure their foreign holdings so that a subsidiary possessing numerous passive assets is the parent of many active manufacturing subsidiaries, and thereby take advantage of the look through rules.[94]

By sweeping so broadly, the asset test furthers Efficiency by ensuring that more foreign subsidiaries will not derive any benefits denied to domestic corporations. In the process, however, the asset test sacrifices the goal of Competitiveness by forcing active overseas manufacturing operations to be subject to the PFIC regime, thereby increasing their tax liabilities over what they would be if they were only subject to the Subpart F regime.

3. *Regulated Investment Companies*

Lastly, PFIC can have particularly disastrous results for Regulated Investment Companies,[95] the exact same companies that the regime was intended to help.[96] Specifically, the PFIC regime subjects any RIC which owns stock in a PFIC to two levels of taxation instead of one.[97]

RICs, in order to comply with the asset diversification requirements imposed by the Code, often cannot own a large percentage of any corporation.[98] Therefore, if an RIC invests in a PFIC, it is doubt-

94 There are numerous advantages, for example, of creating one single finance subsidiary overseas to hedge against any foreign currency losses. If a company has both a German manufacturing company which creates a lot of payables denominated in the German Mark and a sales subsidiary which generates primarily receivables generated in the German Mark, it would behoove the U.S. parent to create a finance subsidiary. This is because instead of having both the manufacturing and sales subsidiary hedging their positions, the finance subsidiary can be more efficient by looking at the overall picture and seeing whether there is a "net asset" or "net liability" position which needs to be hedged. Richard J. Shapiro and Roger D. Lorence, *PFICs Pose Significant Hazards for U.S. Investment Companies*, 2 J. INT'L TAX'N. 185 (1991). The problem is that any gains or losses on currency contracts will be considered passive. This is because passive income for purposes of § 1296(b) is Foreign Personal Holding Company Income. Foreign Personal Holding Company Income includes the excess of foreign currency gains over foreign currency losses. I.R.C. § 954(c)(1)(D).

However, by placing the finance subsidiary on top of the sales and manufacturing subsidiaries, the § 1296 look through rules work in favor of the finance subsidiary by imputing the active assets of the two second tier subsidiaries to the finance subsidiary and helping to avoid the asset test. Bruce W. Reynolds, Nicholas J. Denovio, and George Mundstock, *RRA '93 Anti-Deferral Provisions Create Planning Hurdles for CFCs*, 5 J. INT'L TAX'N. 52 (1994).

95 Recall that Regulated Investment Companies are those domestic corporations registered under the Investment Company Act of 1940. I.R.C. § 854(a)(1)(A).

96 Labrenda Garret Stodghill, *Applying PFIC Rules to RICs Can Cause Double Taxation*, 2 J. INT'L TAX'N. 100 (1991).

97 *Id.*

98 An RIC cannot have more than 25% of its total assets (measured by value) invested in the securities of any one issuer. I.R.C. § 851(b)(4)(B).

ful the RIC will be able to make a QEF election.[99] The RIC will therefore be trapped under the interest charge regime, which imposes two taxes.[100] The RIC will pay the tax computed under the interest charge method on any excess distribution, and the shareholder of the RIC will pay another tax when the RIC receives a dividend.[101]

So, by trying to preserve the tax base, the Code sacrifices Efficiency by penalizing RICs which invest in foreign corporations as opposed to domestic corporations. Although not every foreign subsidiary is a PFIC, it has been illustrated that it is difficult to determine which companies will be PFICs, and once they are considered PFICs it is too late to do anything about it.[102]

B. Overlap Problems

A frightening new level of complexity presents itself when more than one regime applies to the same corporation. Although the Code provides basic guidance with respect to the interaction of the various regimes,[103] the application of multiple regimes tends to cause an exponential degree of complexity with a corresponding sacrifice of the goal of Simplicity.

In order to avoid being caught under the PFIC regime, many U.S. shareholders use the look through rules to their advantage by structuring their holdings overseas such that the first tier foreign subsidiary is a company with primarily passive assets. However, if the foreign subsidiaries are both CFCs and PFICs then both the Subpart F and PFIC provisions apply, and the aforementioned tax planning tip becomes useless.[104]

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99 "While a QEF election would enable a RIC to avoid tax at the RIC level (by virtue of a distribution equal to the income deemed received), this election is not a practical solution for the large number of RICs whose ownership percentages in PFICs do not carry sufficient influence to cause the PFIC to comply with the accounting and reporting requirements prescribed by Treas. Reg. § 1.1295-1T. Thus the typical RIC holding PFIC stock is subject to the interest-charge regime for non qualified funds." Labrenda Garret Stodghill, *Applying PFIC Rules to RICs Can Cause Double Taxation*, 2 J. INT'L TAX'N. 100 (1991).

100 *Id.*

101 *Id.*

102 This is because § 1297(b)(1) mandates that once you are a PFIC you are always a PFIC.

103 Basically, § 951(d) states that Subpart F inclusions have priority over FPHC inclusions, and § 951(f) states that Subpart F takes precedence over PFIC inclusions. Finally, § 551(g) states that FPHC inclusions have precedence over § 1293 PFIC inclusions.

104 Under the Subpart F rules, such a corporate structure only increases the active manufacturing subsidiary's chances of being caught holding excess passive assets, and therefore subject to a Subpart F inclusion. This is because § 956A treats CFC "groups" meeting certain stock ownership requirements as one corporation. For an extremely thorough analysis of the intracacies of § 956A *see* Peterson, Jr., et. al., *supra* note 52.

Another odd result occurs when a foreign subsidiary is both a CFC and a FPHC. Under the Subpart F rules, income which is already subject to high tax rates[105] is NOT considered Subpart F income and so is not subject to current taxation.[106] However, if the CFC is also a FPHC, the income would be subject to current taxation.[107] There does not seem to be any rational justification for the difference.

This complex overlap also gives rise to opportunity. For example, an advantage of being both a CFC and a PFIC is that the astute tax planner may be able to play one regime off of the other. Specifically, it may be possible to avoid the interest charge regime without making a QEF election.[108] The advantage of this would be partial deferral of

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105 High rates of tax are defined as tax rates which exceed 90% of the tax rates imposed by I.R.C. § 11. I.R.C. § 954(b)(4).

106 I.R.C. § 954(b)(4).

107 Under present law the "high tax exception" of § 954(b)(4) does not apply to a company which is both a FPHC and a CFC. H.R. Rep. No. 353, at 104.

108 § 1297(b)(9) states that income inclusions under § 951(a)(1)(B) or (C) shall be considered "distributions" for purposes of the PFIC regime. Colman J. Burke, *Excess Passive Asset Rules of RRA '93 Require Current Inclusion in Income*, 79 J. TAX'N. 314, 316 (1993). Income from a CFC is included currently in a shareholder's income under § 951(a)(1)(B) only if the CFC has increased its investment in the United States property determined under § 956. Income from a CFC is included currently in shareholder's income under § 951(a)(1)(C) if the CFC has investments in excess passive assets determined under § 956A. It should be noted that regular inclusions of Subpart F income under § 951(a)(1)(A) are NOT treated as distributions for purposes of the PFIC regime. Treas. Reg. § 1.1291-2(b)(2)(i).

The main advantage to this overlap of the PFIC and CFC regimes is that the CFC can more easily assure avoidance of the interest charge regime, without having to make a QEF election and thereby get the benefit of partial deferral. For example, assume a foreign corporation formed in 1994 is both a CFC and a PFIC. It earns the following amounts:

1994	1995	1996	1997
300	400	500	600

Further assume that the CFC cannot make a cash dividend in 1994, 1995, or 1996 because it would increase the debt to equity ratio of the CFC and cause a violation of a loan covenant or it would decrease the amount of credit available to the CFC. However, the CFC's shareholder's are anxious to earn a return on their investment and they expect to have a distribution of $250 made in 1997, when the CFC will be less leveraged. The CFC basically has three options:

1) They could make a cash distribution of $250 in 1997. This would be unwise, however, because it would be considered an excess distribution and therefore be subject to the interest charge regime.

2) Another alternative might be to make dividend distributions in 1994, 1995, and 1996, thereby ratcheting up the preceding three year average and decreasing the chances that the 1997 distribution will be considered excessive. The problem is that this will decrease cash reserves in those years, which will result in decreased liquidity, something the CFC does not want.

3) A better option would be to invest the following amounts in U.S. property:

1994	1995	1996	1997
$160	$200	$250	$0

income without being subject to the interest charge regime when actual distributions are made.

While the overlap of the various anti-deferral regimes may help preserve the tax base by discouraging foreign investment, it also creates a tremendous amount of complexity without any corresponding advancement of the other international tax goals.

C. The Foreign Tax Credit

Income earned abroad by U.S. citizens or residents is usually taxed by both the United States and the country in which it is earned.[109] Without some type of crediting system, the tax liability imposed by both countries could easily exceed the income upon which the tax was levied.[110] The foreign tax credit mechanism was developed to prevent such double taxation.[111]

Two principles guide the formation and operation of the U.S. foreign tax credit.[112] First, foreign taxes paid by U.S. shareholders should not reduce the tax burden those corporations would have incurred had such income been earned in the United States.[113] Second, foreign taxes paid on one type of income should not reduce U.S. taxes on another type of income.[114] Both principles support Efficiency by ensuring that the tax imposed on each type of foreign income will not be less than the tax imposed by the United States on domestic income.[115]

At its most basic level, the foreign tax credit provides a one dollar reduction in a U.S. shareholder's tax liability for each dollar of foreign

Each of these investments will be considered a "distribution" for purposes of the PFIC regime. The effect is that when the $250 dividend is distributed in 1991, it will not be considered an "excess distribution" and will therefore not be subject to the interest charge method. The advantage of the third option is that the CFC's shareholders still get the benefits of partial deferral (i.e.- $140 is deferred in 1994), the eventual distribution of cash will not be subject to the interest charge regime, and yet the subsidiary does not have to make a series of cash distributions when it cannot afford to do so. The only downside to this is that the parent will have to pay tax on the triggered Subpart F inclusions when they are made.

109 Richard M. Hammer & Wesley N. Riemer, *Coping With Separate Foreign Tax Credit Limitations*, 1 J. INT'L. TAX'N. 5 (1990).

110 Roin, *supra* note 3, at 923.

111 Roin, *supra* note 3, at 925-27.

112 Charles I. Kingson, *The Foreign Tax Credit and its Critics*, 9 AM. J. TAX POL'Y. 1, 2 (1991).

113 *Id.* at 2.

114 *Id.* at 2.

115 *Id.* at 3. The foreign tax credit mechanism eliminates the incentive, which is present under an exemption system, for U.S. MNCs to invest in low tax jurisdictions. Under a credit system, a corporation will always pay tax at least at the U.S. rates. On the other hand, an exemption system works by simply exempting foreign source income from a company's gross income. The exemption system provides an incentive to invest in lower tax jurisdictions because corporations operating there pay a lower absolute tax liability. Roin, *supra* note 3, at 924-25.

taxes paid.[116] Therefore, if a U.S. shareholder has a U.S. tax liability of $100 and pays $40 of foreign taxes, the U.S. tax liability should be reduced to $60.

If the foreign tax credit were this simple, however, the United States Treasury would end up subsidizing those countries which tax at higher rates.[117] To prevent this "subsidization dilemma" from eroding U.S. tax receipts, the Code contains two foreign tax credit limitations.[118] Each limitation furthers one of the two aforementioned principles which guide the foreign tax credit.

The first principle, that foreign taxes paid by U.S. owned foreign corporations should in no way reduce the tax burden those corporations would have incurred had such income been earned in the United States, is furthered by the overall limitation. This limitation works by allowing a credit for foreign taxes equal to what the taxes would have been on the income had it been earned in the United States.[119] Therefore, if a foreign subsidiary earns $1,000 and pays foreign taxes of $500, the credit is limited to what the U.S. tax would be on $1,000, or $340.[120]

However, the overall limitation can be circumvented if the U.S. shareholder is allowed to own other foreign corporations which generate low-tax foreign source income in order to use up the excess credits generated from their operations in high tax countries, and thereby violate the second principle guiding the foreign tax credit, that foreign taxes on one type of income should not reduce U.S. taxes on other types of income.[121] This principle is advanced through the use of the

116 "The basic mechanism is quite simple: Taxpayers generate one dollar of tax credit for each dollar of foreign income tax they pay or accrue during the course of a year." Roin, *supra* note 3, at 926.

117 For example, assume a domestic corporation generated $2,000 of domestic income, incurring $680 of U.S. tax, and $1,000 of income earned abroad, incurring $680 of foreign tax. If there were no limit on the amount of the foreign tax credit, the U.S. would receive absolutely no income tax revenue, and the foreign government would receive $680. Effectively, the United States would be subsidizing the ability of foreign countries to tax at rates higher than our own!

118 I.R.C. § 904.

119 I.R.C. § 904(a).

120 Assuming an average tax rate of 34%.

121 Richard M. Hammer & Wesley N. Riemer, *Coping With Separate Foreign Tax Credit Limitations*, 1 J. INT'L TAX'N. 5 (1990). For example, assume that P, a domestic MNC, owns 100% of S1, an active manufacturing enterprise in Germany. Further assume that S1 earns $200 of income and incurs $100 of German income taxes. P will only be allowed a $68 credit for the foreign taxes paid by S1, because § 904 limits the foreign tax credit to what the tax would be if it were earned in the United States. Therefore the tax credit limit would be 34% of $200 or $68.

This leaves P in a $32 "excess credit position." However, P can utilize that extra $32 of excess credits by generating low tax income. For example, assume P also owns S2, an investment company located in a tax haven country. Further assume that S2 generates $100 of income and separate limitation categories.[122] Since the main purpose of the separate limitations is to prevent corporations from offsetting high and low taxed income, the categories typically target income which is 1) easily moved from one jurisdiction to another; 2) bears little foreign tax; or 3) bears abnormally high rates of foreign tax.[123]

The separate limitations operate by categorizing income into various baskets.[124] Each basket then has its own foreign tax credit limitation.[125] As a result, it is more difficult for corporations to offset low taxed income of one type against higher taxed income of another type.[126] However, because there can be high and low taxed income within each basket, the offsetting problem can occur within each basket. This potential for abuse caused Congress to create something called the "high tax kick-out," which takes passive income out of the passive income basket if it is subject to high tax rates.[127] As a result the corporation cannot derive the offsetting benefits referred to above.[128]

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no foreign tax liability. Now, P will have 300$ of foreign income, with a foreign tax credit limitation of $102 and only $100 of foreign tax liability. The excess credit has been soaked up by the income generated in the tax haven country. Richard D. Teigan, *International Taxation: A Guide For U.S. Corporations*, 18 WM. MITCHELL L. REV. 291, 318-319 (1992).

122 Richard D. Teigan, *International Taxation: A Guide For U.S. Corporations*, 18 WM. MITCHELL L. REV. 291, 318-319 (1992).

123 Raymond Turner, *Foreign Taxation Highlights of the Tax Reform Act of 1986*, 21 INT'L LAW. 487 (1987).

124 These baskets are listed in I.R.C. § 904(d)(1)(A)-(I).

125 I.R.C. § 904(d) states that the Foreign Tax Credit limitation in § 904(a) applies separately to each item of income outlined in § 904(d)(1)(A)-(I).

126 Refer to the previous example where P, a domestic MNC, owns 100% of S1, an active manufacturing enterprise in Germany. Recall that S1 earned $200 of income and incurred $100 of German income taxes. P then used S2, which generated $100 of tax free income to use up the excess credits he had from S1's activities. Teigan, *supra* note 121, at 318-319. Congress has prevented this maneuver by creating a separate basket for passive income. § 904(d)(1)(A). Therefore, in the above example, the foreign tax credit limitation would be computed separately for the $200 of active German income and for the $100 of tax free income. The result is that P is only allowed to credit $68 of foreign taxes against his U.S. tax liability. The limit on the $200 of German income is 34% of $200 or $68. The limit on the tax free income is 34% of $100 or $34 but there are no taxes on this income so the tax credits are useless. The effect of the separate limitation categories is to reduce the allowable foreign tax credits by $34. ($102 computed without separate baskets - $68 computed with separate limitation baskets).

127 I.R.C. § 904(d)(2)(A)(iii)(III) takes "high taxed income" out of the passive income limitation basket and places it in the general income basket. Passive income is "high taxed" if the foreign income taxes paid on such income exceeds the highest rate specified in § 11 (which is currently 35%). I.R.C. § 904(d)(2)(F).

128 For example, assume that domestic corporation P owns S, a controlled foreign corporation which has $100 of passive income subject to a 10% tax rate and $100 of passive income subject to a 50% tax rate. Without the high tax kickout, the $200 of passive income would go into the passive income basket provided for in § 904(d)(1)(A), which would result in a $68 basket limitation. As a result all $60 of foreign tax would be creditable against P's U.S. tax. However the high

However, one will never fully eliminate this "offsetting" problem unless one creates a separate basket for every single transaction that a foreign corporation engages in.[129] Although Congress has not yet taken this extreme position, it has done something similar with its creation of a separate basket for non-controlled foreign corporations.[130] This is a separate basket for U.S. MNCs which own at least 10%[131] but less than 50%[132] of a foreign corporation ("10-50 companies").

The foreign tax credit mechanism furthers four international tax goals. By allowing any credit at all, the Code decreases the chances for double taxation and so furthers the goals of Competitiveness, Compatibility, and Efficiency.[133] By imposing a cap on the credit, the Code preserves the tax base by eliminating the tax incentive for operating in high tax jurisdictions. However, the cap also thwarts both Efficiency and Competitiveness by forcing some U.S. companies to pay more in taxes because they operate abroad.[134] Moreover, as illustrated above,

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tax kickout removes the $100 which is subject to the 50% tax rate from the passive basket and places it into the general limitation basket. § 904(d)(2)(A)(iii)(III).This is because the 50% rate exceeds the maximum rates for corporations outlined in § 11. As a result, two limitations will be computed. The passive income basket will have a $34 overall limitation. (Assuming a 34% average U.S. tax rate). The entire $10 of tax generated on the low taxed passive income in the passive income basket will be allowed as a credit. However, only $34 of the foreign taxes paid on the passive income in the general limitation basket will be creditable against U.S. taxes. $16 will be unsheltered by the foreign tax credit.

129 This is often what is referred to as the "transactional approach" to the foreign tax credit. Charles I. Kingson, *The Foreign Tax Credit and its Critics*, 9 AM. J. TAX POL'Y. 1, 17 (1991).

130 I.R.C. § 904(d)(1)(E) establishes a separate limitation category for dividends from a non controlled § 902 corporation.

131 A parent corporation must own at least 10% of its foreign subsidiary in order to be eligible for a foreign tax credit under § 902(a).

132 A controlled foreign corporation is a corporation in which over 50% of the vote or value of the corporation is owned by U.S. shareholders. I.R.C. § 957(a). Congress passed the separate basket for 10-50 companies because it was afraid that U.S. MNCs were acquiring foreign operations solely for the ability to utilize their foreign tax credits. However, the idea that U.S. corporations would make such a significant investment overseas without a legitimate business reason is somewhat difficult to believe. Richard M. Hammer & Wesley N. Riemer, *Coping With Separate Foreign Tax Credit Limitations*, 1 J. INT'L. TAX'N. 5 (1990).

133 "[B]y removing what would otherwise represent a significant disincentive for foreign investment, the foreign tax credit promotes both efficiency and competitiveness. " Alan Wilensky, *International Tax Reform: An Interim Report*, 93 TAX NOTES INT'L. 15-12 (Jan. 15, 1993). Moreover, since the foreign tax credit helps prevent double taxation, it furthers the goal of compatibility with international tax norms.

134 *Id.* "The foreign tax credit limitation can be considered to detract from economic efficiency because the inability to credit excess foreign taxes against U.S. tax on U.S. source income can result in a greater overall tax burden for foreign than for domestic investment.... Restrictions on cross-crediting are often considered to impair competitiveness by subjecting U.S. investors to a greater overall tax burden than their foreign competitors...."

in order to make the various caps work, so many complex rules are needed that Simplicity is completely abandoned.[135]

III. The Proposed Passive Foreign Company Regime

It has often been said that "Congress legislates in haste and repents at leisure, if ever."[136] This is especially true in the area of international taxation. Ever since the first anti-deferral regime was implemented, the area of international taxation has only become more convoluted. Yet, it was not until 1990 that Dan Rostenkowski, then Chairman of the House Ways and Means Committee, called for a simplification of the Code which included reformation of the several anti-deferral regimes.[137] Congressman Rostenkowski laid out six goals which would be necessary for any simplification measure. The bill would have to:

- Reduce record keeping
- Reduce compliance costs
- Not create opportunities for abusive tax planning
- Create benefits from simplification which would outweigh the costs resulting from changing the Code
- Not result in a shift of the tax burden among taxpayers
- Comport with current budget constraints[138]

In response, Congress developed the Passive Foreign Corporation (PFC) regime.[139] This anti-deferral regime has itself been deferred in that it, in varied forms, has been up for consideration by Congress three times but has not yet been passed.[140] The purpose of this part is

135 A Treasury Report discussing international tax policy, released in January, 1993, stated, "The application of multiple separate limitations, however, has made the foreign tax credit provisions the clearest example of excessive complexity in the international rules." *Id.*

136 James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 Tax L. Rev. 7, 14 (1989).

137 137 Cong. Rec. H5232 (1991).

138 *Id.*

139 The House report accompanying the bill describes some of the current problems: "Some regimes preserve the character of the income earned in the hands of a foreign corporation while others do not. Some provide for movement of losses between years of a single foreign corporation or between multiple corporations while others do not. While a consistent theme of these regimes is to provide current taxation for certain types of interest, dividend, rental, royalty, and other similar income, the different regimes apply different criteria to these items of income to determine their current inclusion or non inclusion.... consolidation of the operating rules permits more uniform extension of those benefits to all taxpayers subject to the current inclusion regime." H.R. Rep. No. 103-353.

140 The PFC legislation was included in H.R. 11 in 1991, which eventually was vetoed by President Bush. It was resurrected again in very similar format again the next year in H.R. 4210. This legislation was also vetoed by President Bush. In 1993 the House Ways and Means committee made certain minor modifications to the PFC legislation and referred it to the Senate for further consideration. The Senate chose not to act on the legislation and it is no longer pending. Many people have speculated why the legislation was not passed in the Senate. One possible

to describe the PFC regime and examine whether it interacts with international tax goals better than its predecessors.

The PFC regime is really a composite of three mechanisms which determine the amount of a foreign corporation's income which will be subject to current taxation.[141] The regime would repeal the FPHC and PFIC regimes and would exempt foreign corporations from the AET and PHC regimes.[142] However, the regime would retain and work in tandem with Subpart F.

A. Operation of PFC Regime

A foreign corporation is a passive foreign corporation, or PFC, if: 1) sixty percent or more of its gross income is passive income, or 2) fifty percent or more of its assets (on average during the year measured by value) produce passive income or are held for the purpose of producing passive income, or 3) the company is registered under the Investment Company Act of 1940 as a management company or a unit investment trust.[143] The PFC regime ends deferral through three different mechanisms: 1) current inclusion, 2) mark-to-market or 3) interest charge.[144]

1. Current Inclusion

If a PFC is U.S. controlled,[145] then all of the PFC's shareholders must use this method of income inclusion.[146] A shareholder must also use this method if he or she owns twenty-five percent or more of a non-U.S. controlled PFC.[147] However, even if shareholders are not re-

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explanation is that the Senate Finance committee was also at work on health care legislation that year. Another explanation is that the PFC regime, standing alone, was a revenue loser. To make up for the lost revenues, the bill was going to impose a UBIT, or Unrelated Business Income Tax, on not-for-profit corporations which received dividends from foreign companies. Both these explanations were confirmed in a telephone interview between the author and a Democratic House Ways and Means Committee Aide. However, tax analysts cited additional reasons. For example, one commentator remarked that since the PFC regime retained three income inclusion methods, it would not be much easier to apply than the current series of regimes. John Turro, *Bill Could Force Exempts to Pay UBIT on Foreign Dividends.*, 63 TAX NOTES 1085 (May 30, 1994). Other commentators note that since the PFC retains the asset test, many people feel that the PFC, much like the PFIC regime, sweeps far too broadly. *Foreign Simplification Bills Seen Getting Weak Support*, 233 DAILY TAX REP. 6, 8 (1991).

141 *See* H.R. Rep. No. 353, at 103-112.

142 H.R. 3419, 103d Cong., 1st Sess. § 401 (a-b) (1993).

143 H.R. Rep. No. 353, at 101.

144 H.R. Rep. No. 353, at 103-112.

145 "U.S. controlled" has the same meaning under Subpart F and the Foreign Personal Holding Company Regime. *See* H.R. Rep. No. 353, at 104.

146 *Id.* at 103.

147 *Id.*

quired to use this method of income inclusion they may still elect it if they wish.[148] This method is very similar to the QEF election currently available to shareholders in a PFIC. This method requires that the shareholder currently include 100% of the PFC's income in his or her income.[149] The current inclusion mechanism accomplishes this by first deeming the subsidiary to be a CFC if it is not already a CFC.[150] It then labels all of a PFC's income as Foreign Base Company Income (a component of Subpart F income), which is then imputed to the shareholders of the "deemed CFC" through the regular § 951(a)(1)(A) Subpart F rules.[151] Any actual PFC distribution will be treated as a distribution of previously taxed income and will not be taxed again.[152]

2. *Mark-to-Market*

If a PFC shareholder owns less than twenty-five percent of the corporation, and the corporation is not U.S. controlled, then he or she may use the mark-to-market method of income inclusion.[153] This method requires the shareholder to annually mark his or her shares to market and recognize as income any excess of the fair market value of his or her PFC stock over its adjusted basis.[154] Unlike the current inclusion mechanism, this mechanism does not flow through the Subpart F rules and simply imputes the income to the shareholder itself.[155]

If the adjusted basis of the stock exceeds its fair market value then the taxpayer is allowed a deduction.[156] However, this deduction is limited to the "unreversed inclusions" of the PFC stock.[157] Unreversed inclusions are defined as the total excess of prior gains over

148 *Id.* at 105.

149 *Id.* at 101.

150 Under the PFC regime this would be the new I.R.C. § 1292(a)(1)(A)(iii); H.R. 3419, § 402.

151 This has been the operation of the bill in its 1992 and 1993 versions. However, it should be noted that the 1991 version labeled the income FPHC income, rather than foreign base company income. H.R. 2777, 102d Cong., 1st Sess. § 301 (1991).

152 H.R. 2777, § 311.

153 This is assuming that they did not make the current inclusion election. H.R. Rep. No. 353, at 105.

154 The character of this income is ordinary income. H.R. Rep. No. 353, at 106.

155 H.R. 3419, 103d Cong., 1st Sess. (1993).

156 H.R. Rep No. 353, at 106.

157 *Id.* For example, if the fair market value of a PFC, with an adjusted basis of $50, was as follows:

1995	1996	1997	1998
60	62	63	48

prior losses recognized for the PFC stock.[158] The effect of this limitation is to prevent the shareholder from ever recognizing an overall loss on the stock.

3. *Interest Charge Method*

The mark-to-market method is only a viable alternative if the PFC's stock is "marketable."[159] Therefore, shareholders who are not forced to use, or do not elect to use, the current inclusion method, are forced to use the interest charge method if their PFC shares are not marketable.[160] This interest charge method operates basically the same as the PFIC interest charge method.

B. What does the PFC Regime solve?

1. *Complexity*

The main benefit of the PFC regime is that it decreases the sheer number of regimes that the tax planner must deal with from six to two. Therefore, in this respect, the PFC regime advances the goal of Simplicity.[161]

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the shareholder would recognize the following income inclusions under the mark to market method:

1995	1996	1997	1998
10	2	1	(13)

The full $15 of loss is not allowed as a deduction in 1998 because of the "unreversed inclusion" limitation.

158 *Id.*

159 Marketable stock is stock which is regularly traded on a "qualified exchange" either inside or outside the United States. A qualified exchange is any exchange: 1) registered with the SEC; 2) registered with the national market system; 3) the secretary of the Treasury believes ensures market prices which represent a legitimate and sound price for the stock; or 4) any PFC stock held by an RIC that continuously offers for sale or has outstanding any stock (of which it is the issuer) which is redeemable at its net asset value. H.R. Rep. No. 353, at 106-107.

160 H.R. Rep. No. 353, at 110.

161 However, some analysts have argued that the PFC regime will not have a large impact on complexity, because it still contains three income inclusion methods and the transition rules between these three methods are going to require extremely tedious regulations from the Treasury Department. Jessee R. Rubin, *Simplifying Taxes on Offshore Investment Co. Shareholders.* 52 TAX NOTES 1299, 1305 (1991). Yet, this criticism is probably without merit. The transition rules between the current inclusion and mark-to-market methods should not be very complicated since they both subject income of the PFC to current taxation and raise the basis of the stock in the hands of the shareholder accordingly. The mark-to-market method increases the basis in § 1291 of the proposed legislation. H.R. Rep. No. 3419, 103d Cong., 1st Sess. (1993). The current inclusion mechanism increases the basis because it imputes the PFC's income to the shareholder through the Subpart F rules, which increase the stock's basis through § 961.

Since the amount included in income every year under the two methods may be different, the basis adjustments are necessarily going to be different under the two methods. Yet, it is

2. *RICs*

Another benefit of the PFC regime is that it allows for one level of taxation for RICs by treating any PFC stock held by an RIC, as marketable.[162] The RIC then includes the income of the PFC based on the mark-to-market method just as if it was a dividend from any other corporation. Therefore, as long as the RIC distributes ninety percent of its investment income, it will only be taxed once![163] This helps to preserve the tax base by eliminating the dual tax imposed on RICs by the interest charge method of the PFIC regime.

3. *Mark-To-Market*

It is often difficult for minority shareholders to provide the information required by I.R.C. § 1295 in making a QEF election, but they do not want to be subject to the interest charge method either, for the reasons discussed in Part II(A)(6). The mark-to-market method offers a good compromise to those shareholders who do not have the power

difficult to see why that alone necessitates a complex series of transition rules. The basis under the mark-to-market method could be the beginning basis under the current inclusion method and vice-versa. Therefore, no transition rules would really be necessary at least between these two methods. Although this may mean that shareholders in the same PFC may realize different amounts of income over time, such a disparity is inherent with any regime which has multiple income inclusion methods.

Moreover, any rules needed to govern the transition between either the mark-to-market or current inclusion and the interest charge method would not be any more difficult than what is currently in place under the PFIC regime to govern the transition between the interest charge method and the QEF election. Therefore, the criticism that the PFC regime does not eliminate complexity because certain transition rules will be required is probably unfounded.

162 H.R. 3419, § 402(a).

163 The Joint Committee on Taxation confirmed that the bill will treat all the stock in a PFC, which is held by an RIC, as marketable stock. The committee also confirmed that any income inclusion under the mark-to-market regime would count towards the 90% dividends received deduction under § 851(b)(2). Joint Committee on Taxation, *JCT Issues Revised Report on Simplification*, 92 TAX NOTES TODAY 50-18, (1992). Therefore, the RIC can avoid paying the corporate level tax on PFC income the same way they eliminate the corporate level tax on income from domestic stocks. They simply have to distribute 90% of the income. One criticism of this approach is that basically, the legislation forces an RIC to distribute 90% of an amount which it may not have! The amount of income an RIC realizes currently does not have to bear ANY relationship to the amount of dividends actually distributed by the PFC. So, if the market value of the RIC's PFC stock increases by $100, the RIC will be required to distribute $90 in order to avoid the corporate level tax. § 851(b)(2). However, the RIC may have not received any cash from the PFC at all. Therefore, this legislation requires the RIC to distribute 90% of the PFC's income to its shareholders, even though the RIC may not have any cash with which to make such a distribution!

However, in defense of the PFC regime, it would seem that this liquidity problem would be inherent in any abandonment of the classical tax system. Moreover, this modification is definitely an improvement over the two levels of tax which are imposed under the interest charge method of the current PFIC provisions.

to get the information required for the QEF election, but still wish to avoid the interest charge method. This mark-to-market method alternative also advances the goal of Simplicity because it is fairly easy to apply.

4. *High Tax Exception*

One specific problem the PFC solves is the anomaly alluded to previously where a company which is both a FPHC and a CFC is denied the high tax exception allowed for companies which are only CFCs. The PFC regime eliminates this anomaly by eliminating the FPHC provisions.[164]

C. What does PFC miss?

1. *Income Allocation*

Since the interest charge method of the PFC regime is almost identical to the interest charge method employed under the PFIC regime, all the same problems arise. For example, by failing to tie income allocations to those years when income is actually earned, the PFC penalizes corporations which are not really deferring income, just like the PFIC regime.

2. *Overlap Advantage*

Under the PFIC regime, distributions under § 956 and § 956A are considered "actual distributions" for purposes of the interest charge method, but regular Subpart F inclusions are not.[165] It was demonstrated earlier in this paper how this can lead to partial deferral. This is still the case under the latest version of the PFC regime.[166] It would be more logical for the PFC regime to either qualify all Subpart F inclusions as "actual distributions" or disqualify all of them. By not solving this problem, the PFC regime advances Competitiveness, because the foreign corporation might be able to achieve partial deferral. Yet that necessarily means that the goal of Preservation is sacrificed because U.S. citizens have more of an incentive to invest abroad.

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164 This is described in what would be the new I.R.C. § 1292(a)(1)(B). H.R. Rep. No. 3419, § 402.

165 I.R.C. § 1297(b)(9).

166 § 1297(d)(6) of the 1993 version of the PFC regime is similar to the language which is currently in I.R.C. § 1297(b)(9). H.R. Rep. No. 3419, 103d Cong., 1st Sess. (1993).

3. *Installment Sales*

The 1991 and 1992 versions of the PFC legislation contained provisions which denied installment sales treatment to the sale of PFC stock which was subject to the interest charge method.[167] The purpose of this was to prevent a sale, which would be considered an excess distribution, from escaping the interest charge method by simply spreading the payments over a period longer than a year. The 1993 version of the PFC rules do NOT deny installment sales treatment to sales of PFC stock, even though it would seem prudent to have such a provision in the regime.

4. *Income Characterization*

While the character of the PFC's income, ordinary income or capital gain, is passed through to the shareholder under the current inclusion method, *all* of the income of the PFC is treated as ordinary under the mark-to-market method.[168] The current inclusion method furthers Efficiency, because domestic entities with pass-through tax treatment, like partnerships, pass through the character of their income to their shareholders. Conversely, the mark-to-market method thwarts Efficiency by not passing through the character of the gain.

IV. An Analytical Framework for International Tax Reform

Thus far, this comment has demonstrated that the current international tax system both furthers and sacrifices each of the five international tax goals outlined at the beginning of this paper. The PFC reform proposal falls into the same trap. Since there is no overarching goal against which to measure success, neither the current system nor the proposed PFC system can really be said to be better. Therefore, this part will attempt to identify a primary goal for the United States' system of international taxation against which the success of a particular regime may be measured.

On January 25, 1993, the U.S. Treasury issued a preliminary report outlining the options the United States had for reform in the area of international taxation.[169] After describing the five goals which have been discussed throughout this paper, the report states that the goals of Efficiency and Competitiveness are incompatible and cannot be ad-

167 § 302(b) of H.R. Rep. No. 2777, § 302(b).
168 § 1291; § 1292;§ 1293 or the proposed legislation. H.R. Rep. No. 3419, § 402.
169 Wilensky, *supra* note 133, at *id.*

vanced through the same tax regime.[170] To that end, the report outlines the principles a regime for each goal.

The problem with the Treasury Report is that it ends without developing any analytical framework for choosing which goal should be advanced.[171] Instead the report starts with two incompatible goals and then is forced to develop a regime for each of these goals.

This article suggests that the analytical framework consist of a two step process. First, complementary and noncomplementary sets of goals should be identified. Second, from the largest complementary set, the goal which provides the most guidance for the development of a tax regime should be chosen as the primary goal.

Complementary and noncomplementary sets should be determined. Complementary sets consist of two or more goals which may be advanced simultaneously. Noncomplementary sets consist of two or more goals, where the advancement of one goal necessarily means that the other is thwarted.

Preservation and Competitiveness form a noncomplementary set, because the advancement of one automatically means the other is sacrificed. Competitiveness requires that U.S. owned foreign corporations be taxed at the same rate as their foreign competitors. This means that U.S. owned foreign corporations operating in tax haven countries may not pay any U.S. income tax. However, this would create a massive incentive to liquidate U.S. investments and invest abroad, which would sacrifice Preservation.

Similarly, Competitiveness and Efficiency form a noncomplementary set, because Competitiveness requires that U.S. owned foreign corporations operate without a tax disadvantage. As long as the foreign jurisdiction is a high tax jurisdiction, both goals can be satisfied. However, in the event that a U.S. owned foreign corporation is located in a tax haven, Competitiveness requires no additional U.S. taxes be imposed, whereas Efficiency requires the imposition of U.S. taxes to eliminate the disparity between the taxes imposed by the tax haven and the taxes imposed by the United States.

Lastly, Preservation forms a noncomplementary set with Compatibility. Compatibility mandates the elimination of discrimination whereas Preservation fosters it by imposing additional U.S. taxes only upon those U.S. owned foreign corporations which choose to operate

170 Wilensky, *supra* note 133, at *id.*
171 Wilensky, *supra* note 133, at *id.*

in lower taxing jurisdictions.[172] However, since there is no corresponding reduction of tax liabilities for corporations operating in high tax jurisdictions, Preservation discriminates solely against low tax jurisdictions and therefore necessarily violates international tax norms.

Every other goal is potentially complementary to the other goals. As a result, the largest complementary set would be one which excludes Competitiveness and Preservation. By elimination, this set would include the goals of: Efficiency, Compatibility, and Simplicity.

The second stage in the analytical framework is to choose from this complementary set the primary goal which provides the most guidance for the development of a tax regime. Simplicity can be eliminated out of hand because it is devoid of analytic content and provides no basis for the creation of a regime. Compatibility similarly adds very little direction to this analysis. Since there is more than one international tax norm, choosing Compatibility as the primary goal would simply exacerbate the current problem. Efficency provides much more guidance.

Choosing Efficiency as a primary goal is problematic, however. Efficiency requires the complete elimination of tax concerns as a component of investment decisions. However, in the absence of global integration of tax systems and rates, such neutrality may be a practical impossibility. One international tax expert, Julie Roin, has suggested that in order to attain "absolute neutrality," or the total elimination of tax considerations as a component of investment decisions, the U.S. would have to subsidize, through the use of an unlimited foreign tax credit, those U.S. companies which desired to invest in foreign countries with higher rates of tax than our own.[173] This is the "subsidization dilemma," referred to above, which would effectively turn the United States system of international taxation into a welfare program for some of the wealthiest industrialized nations on earth.

This is why Roin outlines the concept of "defensive neutrality." This form of neutrality is defined such that the U.S. tax liability of U.S. owned foreign corporations must equal or exceed the tax liability which would be incurred had those subsidiaries been located in the

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172 Although Efficiency also seeks the imposition of additional taxes on U.S. owned corporations operating in tax havens, it also seeks to reduce the tax liability of those corporations which operate in high tax jurisdictions. Therefore, whereas Efficiency seeks to impose the same tax rate on any U.S. owned corporation located in any country, Preservation only concerns itself with imposing U.S. rates on low tax jurisdictions. As a result, Preservation could be said to discriminate whereas Efficiency does not.

173 Roin, *supra* note 3, at 926-30.

United States.[174] The problem is that defense neutrality does not promote Efficiency, because investors are discouraged from investing in those jurisdictions which tax at higher rates than the United States. As a result, the United States may be confronted with the option of absolute neutrality and the subsidization dilemma or abandoning Efficiency as its primary goal.

V. Basic Principles of the New Regime

If Efficiency is the goal to be advanced through the international tax system, a new regime must be developed which equalizes the tax effects of foreign and domestic investments. The principles of the regime would be as follows:

- The first step in such a system would be the complete elimination of deferral. U.S. owned foreign corporations could not be allowed to defer the incidence of U.S. taxation because the existence of tax haven countries means that those corporations could lower the present value of their overall tax liability vis-a-vis domestic corporations.
- This would necessarily also lead to the elimination of deferral for domestic corporations, so that investment in those corporations would not be favored.
- The foreign tax credit limits would have to be repealed in order to eliminate the disincentive to invest in high tax jurisdictions.

Such a regime could be developed by simply modifying the proposed PFC regime such that it would apply to all U.S. citizens and residents owning any amount of stock in any domestic or foreign corporation.

This change would lead to a series of complex ramifications, which must be sorted through. However, some issues would not be as problematic as they first appear to be. For example, the dramatic increase in the present value of shareholder tax liability could be offset by an elimination of the classical tax system and its corporate level income tax. Moreover, although the subsidization dilemma is a vexing problem, it would be mitigated to some extent because the elimination in the corporate level income tax would necessitate a corresponding increase in the individual marginal tax rates in order to make up the revenue shortfall.

If the U.S. utilized this regime, it would not necessarily collect more taxes than foreign countries which adhered to the current classical tax system. Rather, it would collect the same amount of tax, sooner, at one level, than foreign countries, adhering to the classical system, would collect in two stages utilizing two levels of taxation.

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174 Roin, *supra* note 3, at 926-30.

This regime would further Efficiency by subjecting all corporate investments, domestic and foreign, to the same system of taxation. If a U.S. shareholder invests in a low tax jurisdiction, he will have to pay the difference between the U.S. taxes which would have been imposed on that income and the foreign taxes which were paid. If a U.S. shareholder invests in a jurisdiction imposing higher rates of tax than the U.S., then that shareholder will be able to offset those foreign taxes without limit against her U.S. tax liability. However, because U.S. rates will have to be adjusted upward to compensate for the loss of revenue attribuitable to the corporate level tax, this may be a rare occurrence.

Moreover, the other international goals can still be furthered. Since Efficiency is complementary to the goals of Compatibility and Simplicity, those two goals will be advanced simultaneously with Efficiency through the new regime.

Preservation would also be enhanced since the focus of the new income tax regime would be on individuals instead of corporations. Whereas a U.S. citizen currently can defer the U.S. corporate level tax simply by investing outside the country, under the new regime the taxpayer would actually have to "expatriate." That is he would have to renounce his U.S. citizenship and leave the country in order to achieve deferral. Although this may become a problem if more Americans find the choice to expatriate a palatable one,[175] there are numerous factors completely unrelated to the income tax which can be employed to dissuade U.S. citizens from expatriating.[176]

Although this regime would not advance the goal of Competitiveness as it has traditionally been defined in relation to the Code, it would help corporations to be competitive in the international marketplace in a broader economic sense. By making individuals the sole incidence of taxation, the Code would be more efficient and would free businesses and shareholders to make numerous decisions without as much emphasis placed on tax consequences.[177] Probably the most

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175 It should be noted that 306 Americans did in fact expatriate in 1993. Michael Kinsely, *Love it or Leave It*, TIME, Nov. 28, 1994, at 96.

176 As a recent article on the expatriation of wealthy Americans pointed out, the United States could never hope to retain any of its wealthy citizens if income tax rates were the only criteria used in deciding whether or not to stay. *Id.*

177 "While it is difficult to quantify the cost of these distortions [caused by the classical double tax system] to the U.S. economy, the Department of Treasury's 'Report on Integration of the Individual and Corporate Tax Systems' has estimated that integration of the corporate and individual tax system to eliminate one level of tax would, depending on the form of the integration proposal, increase the capital stock in the corporate sector by $125 billion to $500 billion, decrease the debt-to-asset ratio in the corporate sector by one to seven percentage points, and

important ramification, however, may be the possibility of structuring the regime such that corporations would no longer have a tax preference for debt financing as opposed to equity.[178] This reduction in debt with a corresponding decrease in debt service would also make corporations more competitive in the global marketplace.

VI. Conclusion

In conclusion, this comment recommends that the United States government develop a single regime similar to the one outlined above in order to advance the goal of Efficiency. In the absence of such far reaching reform, however, this comment would at the very least recommend that the United States government: 1) develop an analytical framework through which it can determine which international tax goal it primarily seeks to advance, and 2) advance that goal through a single international tax regime.

produce an annual gain to the U.S. economy as a whole from $2.5 billion to $25 billion (in 1991 dollars). Also, a reduced incentive for debt would make capital structures less vulnerable to instability during economic downturns." Doernberg, *supra* note 13, at 535-36.

178 Doernberg, *supra* note 13, at 537.